

## MEMORANDUM

TO: The Investment Committee of the California Public Employees Retirement System (CalPERS)

FROM: Pension Consulting Alliance, Inc. (PCA)

DATE: April 14, 2006

RE: **Alternative Investment Management (AIM) Benchmark**

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### Recommendation:

PCA recommends that CalPERS consider:

- Continue to use dual benchmarks in evaluating AIM's portfolio performance.
- Continue the use of a U.S. equity market index when calculating its Long-Term Performance Objective, or Opportunity Cost, benchmark.
- Continue the use of rolling ten year periods in the computation of the Long-Term Performance Objective, or Opportunity Cost, benchmark.
- Lower the return premium to 300 basis points to reflect the reduction in risk premium in the market for private investments versus public equities.
- Continue the use of *Venture Economics* young fund median return in computing its Short-Term Performance Objective.

### Discussion:

Currently, CalPERS uses the following benchmarks in evaluating the AIM Program's performance:

- A CalPERS Custom Wilshire 2500 Index plus a 500 basis point return premium smoothed over rolling ten year periods. The rationale behind this benchmark is that it reflects the opportunity cost of investing in alternative investments; i.e., where the money would be invested if not in private equity.
- The *Venture Economics* Young Funds Universe median returns by vintage year are utilized to benchmark the AIM Program's investment performance versus the backdrop of available market opportunities. The young funds are defined as the first four years of each individual partnership and the partnership composite portfolio.

As part of the AIM Program's strategic review, staff asked Russell Investment Group (RIG) for its recommendation on the most appropriate benchmarks for the AIM portfolio. Staff sought Wilshire's input on RIG's recommendation and PCA was asked to review both sets of recommendations and express its conclusions. The recommendations and PCA's analysis are as follows:

- CalPERS currently uses a dual benchmark to measure AIM's investment performance. RIG, Wilshire and PCA agree with the continuation of that approach.

- The current Long-Term Performance Objective benchmark, or Opportunity Cost, is an index comprised solely of domestic equity securities. Wilshire concludes that that is appropriate because when the AIM program was established in 1986, the asset allocation came from domestic equity and fixed income. RIG believes that the allocation comes from domestic and non-U.S. equities and, accordingly, the benchmark should reflect that duality. The System and PCA had the same return expectations for domestic and foreign equity markets during the most recent asset allocation. The historical benchmark reporting has been done using a domestic base. PCA has concluded that it is more appropriate to continue using the domestic index in calculating the Long-Term Performance Objective.
- RIG, Wilshire and PCA agree with the continued use of rolling ten year periods in the computation of the Long-Term Performance Objective, or Opportunity Cost, benchmark.
- Because of the declining risk premium reflected in the market of private investments over public equity, RIG, Wilshire, and PCA believe that the risk premium over public market performance should be lowered from 500 to 300 basis points.
- Currently, AIM uses *Venture Economics* young fund median return in computing its Short-Term Performance Objective (Peer Relative). RIG concluded, and Wilshire concurs, that the AIM program is mature. However, they arrive at different conclusions about the application of that fact to the benchmarks. RIG believes that, because of the maturity, AIM should use a composite universe of shorter and longer horizon funds in the short-term benchmark. Wilshire believes that suggestion intrudes upon the purpose of the long-term benchmark. On this point, PCA agrees with Wilshire. AIM Program personnel longevity has been lower than the contractual life of a private equity partnership (usually ten years). Consequently, it is felt that a shorter term measurement system more accurately portrays the investment performance of the Program's current staff.